
IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

VERNON KEITH GRAVES and
THEODORA GRAVES,

Appellants,

v.

COMMISSIONER OF INTERNAL
REVENUE,

Appellee.

HAROLD J. GRAVES and BEULAH
F. GRAVES,

Appellants,

v.

COMMISSIONER OF INTERNAL
REVENUE,

Appellee.

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APPELLANTS' BRIEF

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APPELLANTS' BRIEF

Appeal from the Tax Court of the United States

STATEMENT OF JURISDICTION

This is an appeal from a decision of the Tax Court of the United States affirming Federal income tax decisions asserted against Petitioners by the Commissioner of Internal Revenue in the below specified amounts for the indicated taxable years resulting entirely from decreases in depreciation deductions on certain property;

	<u>Year</u>	<u>Deficiency</u>
	1958	\$9,182.17
Harold J. Graves and	1961	247.50
Beulah F. Graves	1962	1,062.43
	1963	4,070.59
Vernon Keith Graves	1960	1,063.01
	1961	2,188.27
and Theodora Graves	1962	661.20
	1963	2,218.81

Appellate jurisdiction and venue are granted this court by 26 U.S.C.A., Sec. 7482(a) and 7482(b)(1). The Tax Court had jurisdiction by virtue of 26 U.S.C.A., Sec. 7442. The case of Vernon Keith Graves and Theodora Graves v. Commissioner was consolidated with Harold J. Graves and Beulah F. Graves v. Commissioner in the Tax Court proceedings, and the cases have likewise been consolidated upon this appeal.

STATEMENT OF THE CASE

Petitioners Vernon Keith Graves and Theodora Graves and Petitioners Harold J. Graves and Beulah F. Graves are all residents of Oregon, and hereinafter are collectively referred to as "Petitioners".

Differing from the ordinary depreciation case which primarily involves questions of fact, the following points of first impression are here presented:

Proper application of the "particular business" doctrine of Massey Motors vs. United States, 364 U.S. 92 (1960) to economic useful life of buildings held by an investor for monetary return through leasing.

What constitutes evidence that a depreciation deduction was examined for purposes of Revenue Procedure 62-21, 1962-2 Cum. Bull 418, Subsection 3.05, Part II.

The transcript of the record consists of two volumes. Volume I which includes the stipulation of the parties and the Tax Court findings of fact and opinion is hereinafter referred to as "R". Volume II which contains the report of the proceedings before the Tax Court is hereinafter referred to as "Tr".

Identification of Property

The two buildings in controversy are located on adjoining parcels of real property in Chicago, Illinois. The parcels of real property with the buildings thereon are hereinafter collectively referred to as the "Chicago Property", and the two buildings independent from the real property are hereinafter referred to as the "Chicago Buildings". On and after September 1, 1959, Petitioners owned the following undivided percentage interests

in the Chicago Property:

Harold J. Graves	36.90%
Beulah F. Graves	36.90%
Vernon Keith Graves	10.81%
Theodora J. Graves	.62%

The remaining interests in the Chicago Property are owned by Robert Graves (10.81%, Juanita M. Graves (.62%), and Rex Graves (3.34%), hereinafter collectively referred to as the "other owners". (R. 33, Stip. para 4)

Acquisition and Use of Property
by Petitioners

Petitioners and the other owners acquired the Chicago Property on September 1, 1959 from Sawyers, Inc. in a stock redemption. The Chicago Property was considered to have a fair market value of \$592,057.67 on September 1, 1959, the same as Sawyers, Inc. book value. In return for the Chicago Property, Petitioners and the other owners surrendered Sawyers, Inc. capital stock having a value of \$592.057.67, plus additional Sawyers, Inc. stock for cash. (R. 35, Stip. para 7)

After acquisition on September 1, 1959, Petitioners leased the Chicago Property back to Sawyers, Inc. under a written lease for a five-year term commencing September 1, 1959 and ending August 31, 1964, at a monthly rental of \$3,000. The lease contained a renewal option which Sawyers, Inc. exercised, thereby extending the lease for the five-year period commencing September 1, 1964 and ending August 31, 1969, at a monthly rental of \$3,750. (R. 36, Stip. para 9) Under instrument dated

December 28, 1964, for a \$15,000 consideration, Petitioners and the other owners granted Sawyers, Inc. an option to lease the Chicago Property for another term of five years commencing September 1, 1969 through August 31, 1974 at an annual rental of \$45,000 (R. 36, Stip. para 11). Such option was granted, rather than extending the lease, because Sawyers, Inc. did not want to become obligated through August 31, 1974 (Tr. 56). At the time of the Tax Court hearing on June 30, 1966, Harold Graves had no assurance or expectation that the option would be exercised. (Tr. 56).

Petitioners did nothing with the Chicago Property except lease it as above related.

History of Property Prior to Acquisition by Petitioners

Sawyers, Inc., from which Petitioners acquired the Chicago Property, was a manufacturer of stereoscopic slides, viewers, and other photographic equipment, with home office and manufacturing complex at Progress, Oregon (R. 36, Stip. para 10). In 1951 Sawyers, Inc. purchased one parcel of the Chicago Property (known as 3500 N. Koster Avenue) and constructed the ground floor structure in 1952, adding a second floor during 1954 (R. 34, Stip. para 5). The other parcel of the Chicago Property (known as 3512 N. Koster Avenue), purchased by Sawyers, Inc. from Bell & Howell Corporation on November 28, 1958, included a two story structure constructed in 1952 (R. 34, Stip. para 6).

Sawyers, Inc. used the Chicago Property as a distribution

center, sales office, and for research and development (R. 35, Stip. para 9).

Sawyers, Inc. employed a useful life of 40 years commencing October 1, 1952 for the 3500 N. Koster ground floor, a useful life of 38 years commencing October 1, 1954 for the 3500 N. Koster second floor and a useful life of 34 years commencing January 1, 1959 for 3512 N. Koster (Tr. 64). At the time of the transfer to Petitioners on September 1, 1959, the Chicago Buildings had the following remaining useful lives to Sawyers, Inc.:

	<u>Remaining Economic Useful Life</u>
3500 N. Koster, ground floor	33 years
3500 N. Koster, second floor	33 years
3512 N. Koster	33 years

Harold Graves was president and a member of the board of directors of Sawyers, Inc. from about 1931 to 1957 and was the chairman of the board of directors from 1957 to 1959 (Tr. 57).

Economic Useful Life Used by
Petitioners, and Redetermination
Thereof by Commissioner

For Federal income tax purposes commencing September 1, 1959, Petitioners used an economic useful life of 25 years for the Chicago Buildings, and 5 years for the heating, lighting and plumbing components. Revenue Agents examined the 1959, 1960 and 1961 Federal income tax returns of Harold and Beulah Graves. Based on these examinations, refunds were granted the Graves, and no reductions in depreciation on the Chicago Buildings were proposed (R. 37, Stip. para 13, 14). The 1962 and 1963 income tax returns of Harold and Beulah Graves were examined by a

third Revenue agent who also examined the 1961 return. As a result of such examination, statutory notices were issued determining a 45 year useful life for the Chicago Buildings and a 25 year useful life for the heating, plumbing and electrical components.

Expert Testimony at
Tax Court Hearing

Mr. H. O. Walther testified as Petitioners' expert witness on economic useful life. Mr. Walther is a real estate appraiser and consultant, and has a bachelor degree from the University of Wisconsin with a major in finance, and a master's degree from Northwestern University with land economics as a major. He has been in the real estate financing, appraising and consulting business since 1923. The last 40 years of his experience has been in the Chicago, Illinois area. He is active in appraisal organizations like the American Institute of Real Estate Appraisers, the Society of Real Estate Appraisers, and has been national president of each of these organizations. (Tr. 34 - 35).

Mr. Lawrence N. Kenney testified as the Commissioner's expert witness on useful life. Mr. Kenney is an evaluation engineer with the Internal Revenue Service and served as a consultant in the Revenue Service in the Chicago area in matters pertaining to engineering issues. He had no economic background in regard to real property. All of his background was engineering. (Tr. 67 - 69).

Mr. Walther and Mr. Kenney agreed on the following: The Chicago Buildings are sound, concrete construction in good

condition (Tr. 76, 86). The location of the buildings for commercial and light industrial purposes is excellent from the viewpoint of accessibility (both public transportation and freeway), availability of labor force, and zoning protection (Tr. 80 - 81, 85 - 86).

The following definition of economic useful life constituted the basis for the conclusions of Petitioners' expert witness, Mr. Walther:

How long it takes before the return on the land plus the building would be no more than the return on the land alone.

The definition attributed to Mr. Walther in the Tax Court's opinion (R. 65) is the garbled statement appearing at the bottom of Tr. 86. The definition as phrased above reflects the reiterated statement at Tr. 87. Based on this definition, Walther concluded that the economic useful life from September 1, 1959 was 25 years for the Chicago Buildings and 8 years for the components.

In order to determine economic useful life under the above definition, Mr. Walther stated that a knowledge of market reaction, demand and supply and the adequacy of the present building and surroundings and what it takes to handle the demand and supply. (Tr. 87). Under Mr. Walther's approach, the economic aspects of the Chicago Buildings rather than the physical aspects were dominant (Tr. 86). According to Mr. Walther, useful life in the strict sense had little to do with his determination



(Tr. 87). By useful life in the strict sense, Mr. Walther meant a use not involving the necessities for a monetary return (Tr. 87 - 88).

Quoted below is a key portion of Mr. Walther's testimony made in response to the Court's inquiry concerning Mr. Walther's statement that the Chicago Buildings had "a great deal of obsolescence" (Tr. 46):

"THE WITNESS: First of all, it is a two-story building without an elevator. Therefore, there are only certain types of users who can use this building. It has no sprinkler system in it, it has loading docks which are not the level of the trucks and it has low ceiling heights, it has 12 feet at maximum and if you built a warehouse building today, a one story, the minimum seems to be fourteen and sixteen and they are going as high as thirty because they have no lift trucks which can lift material up much higher. It is because of this built-in obsolescence that that building has a remaining useful life shorter than, for example, a one-story building with a 16-foot ceiling. And as the labor costs go up, they become more and more obsolescent because the labor of moving goods vertically as against moving goods horizontally becomes high and, therefore, the obsolescence in this building makes a shorter remaining useful economic life."

Because of the built-in obsolescence, Mr. Walther emphatically disagreed with the Commissioner's witness that the Chicago Buildings were the highest and best use of the particular land. Mr. Walther defined highest and best use as that use which over the foreseeable future will yield the greatest net return (Tr. 86).

Mr. Kenney, the Petitioners' expert witness, concluded that the useful life from September 1, 1959 was 38 years for the Chicago Buildings and 28 years for the components. Mr.

Kenney did not specify the definition of useful life upon which he based his conclusion. Except for testimony concerning the physical condition of the Chicago Buildings, Mr. Kenney's testimony referred to buildings generally in the area, not the Chicago Buildings in particular. For example, in response to a question concerning the general demand for buildings and rental space, Mr. Kenney replied that: "Buildings of this type, one and two-story structures, are in great demand at all places throughout Chicago, particularly in this area . . ." (Tr. 80 - 81). Similarly, when questioned concerning the present and potential use of the buildings, Mr. Kenney's only reply was that the location is excellent (Tr. 81).

Mr. Kenney testified that the Chicago Buildings represent the highest and best use of the land under his definition of highest and best use: "Best use of that land is to have an industrial building on it." (Tr. 83).

Court Rejected Petitioners' Tender of Appraisal

For reasons not connected with the tax controversy, Mr. Walther made an appraisal of the Chicago Property and Buildings at November 3, 1964 (Tr. 36, 38). In attempting to have this appraisal introduced in evidence, counsel for Petitioners informed the Tax Court that the appraisal established a fair market value for the Chicago Buildings below Petitioners' basis for same (Tr. 38). As explained to the Tax Court, it

is Petitioners' theory that, absent a downward fluctuation in property value, establishment of a fair market value below depreciated basis constitutes evidence that prior depreciation could not have been excessive (Tr. 38, 40) and that the economic useful lives determined by Petitioners were reasonable. The Tax Court rejected introduction of the appraisal for such purpose.

Facts Pertinent to Revenue
Procedure 62-21 Issue

Subsection 3.05, Part II, Revenue Procedure 62-21, 1962-2 Cum. Bull. at 433 precludes the Commissioner from disturbing a depreciation deduction when an audit report ". . . contains comments that the depreciation was examined but not adjusted, or where other specific evidence indicates that the depreciation deduction was examined."

Set forth on the next page is a xerox copy of the rental income and depreciation schedule for the Chicago Buildings which was attached to the 1960 income tax return of Harold and Beulah Graves (and the other Petitioners). An identical schedule was attached to the 1961 returns. As shown on the schedule, Harold and Beulah Graves' share of the Chicago Building loss after depreciation totaled \$2,499.98 (\$1,249.99 each). In the 1960 income tax return of Harold and Beulah Graves, the \$2,499.98 Chicago Building loss was added to a \$237.10 property inspection expense, and the \$2,737.08 total was carried over to the printed part of the return entitled "Income from Rents and Royalties." In the Graves' 1961 return, the \$2,499.98 Chicago Building loss was carried directly to the printed part of the return entitled "Rent and Royalty."

Rental Income Schedule - Chicago Buildings, 1960

Depreciation Schedule

	Date Acquired	Cost	Prior Deprn.	Remaining Cost	Life		Deprn. This Year
					Est.	Rem.	
ding	9-1-59	\$284,648.34	\$ 3,795.31	\$280,853.03	25	24 2/3	\$11,385.93
, plbg.	"	51,159.50	3,410.63	47,748.87	5	4 2/3	10,231.89
ding	"	91,651.82	1,222.00	90,429.82	25	24 2/3	3,666.00
, plbg.	"	39,508.66	2,634.00	36,874.66	5	4 2/3	7,902.00
addition	"	65,566.89	874.23	64,692.66	25	24 2/3	2,622.69
, plbg.	"	17,899.08	1,193.00	16,706.08	5	4 2/3	3,579.00
		<u>\$550,434.29</u>	<u>\$13,129.17</u>	<u>\$537,305.12</u>			<u>\$39,387.51</u>

Total rent received	\$36,000.00
Less - depreciation	<u>39,387.51</u>
Net loss	<u>\$ (3,387.51)</u>

Allocation of net loss:

Harold J. Graves	36.9 %	\$ (1,249.99)
Beulah F. Graves	36.9 %	(1,249.99)
Vernon Keith Graves	11.43%	(387.19)
Robert Graves	11.43%	(387.19)
Rex Graves	3.34%	<u>(113.15)</u>
Total	<u>100.00%</u>	<u>\$ (3,387.51)</u>

Revenue Agent P. M. Andrews issued an audit report dated June 18, 1962 (Exhibit 5-A) covering 1959 and 1960 (also the loss carryback year 1957) which report was forwarded to Harold and Beulah Graves under letter dated July 5, 1962 (R. 37, Stip. para 14). Revenue Agent Conrad S. Miller issued an audit report (Exhibit 7-G) covering 1961 (also the loss carryback year 1958) which report was forwarded to the Graves under letter dated May 24, 1963 (R. 37, Stip. para 15). The covering letters (included as part of Exhibits 5-E and 7-G) state that the enclosed audit reports reflect examinations of the Graves' returns for the specified years.

The audit reports (Exhibits 5-E and 7-G) contain summary schedules for each year showing the items examined and the action taken as a result thereof. Set forth on the next page is a xerox copy extract from the 1960 summary schedule (top half of page) and a xerox copy extract from the 1961 summary schedule (bottom half of page). The \$2,737.08 loss on the 1960 summary schedule opposite "Rents and royalties" is the \$2,499.98 Graves' loss taken from the rental income and depreciation schedule for the Chicago Buildings (copy on page 12) attached to the Graves' 1960 return plus a \$237.10 property inspection expense. The \$2,499.98 on the 1961 summary schedule (bottom half of next page) opposite "Rents and royalties" is the Graves' loss taken from the rental income and depreciation schedule for the Chicago Buildings attached to the Graves' 1961 return.

1960		YEAR END/PERIOD		
1960		YEAR END/PERIOD		
INCOME	RETURN	INCREASE	DECREASE	CORRECTED
salaries, bonuses, commissions compensation.....				
	2,263.25			2,263.25
	1,305.72			1,305.72
annuities				
dividends	(2,727.08)			(2,727.08)
from business or profession	(13,625.33)			(13,625.33)
from farming				
from sale or exchange of assets	1,728.22			1,728.22
from sale or exchange of assets				
losses				
	100.00			100.00
ADJUSTED GROSS INCOME)	(11,015.22) ✓			(11,015.22)

1961		12-19-61		
1961		12-19-61		
INCOME	RETURN	INCREASE	DECREASE	CORRECTED
salaries, bonuses, commissions compensation.....				
	3,120.24			3,120.24
	17,202.20			17,202.20
annuities				
dividends	(2,499.98)			(2,499.98)
from business or profession	(16,264.43)			(16,264.43)
from farming				
from sale or exchange of assets	2,267.92			2,267.92
from sale or exchange of assets				
losses				
Adjusted Gross Income	17,687.34			(17,687.34)

Holding of Tax Court

The Tax Court rejects Petitioners' definition of economic useful life as being a misconception of law (R. 65 - 66), and completely ignores the testimony of Petitioners' expert witness supporting a 25 year useful life for the Chicago Buildings and an 8 year useful life for the components. Adopting the conclusions of the Commissioner's expert witness, the Tax Court held that the Chicago Buildings had a useful life of 38 years and the components had a useful life of 28 years.

The Tax Court denied that Petitioners had brought themselves within Subsection 3.05 Part II of Revenue Procedure 62-21 (R. 63) because (according to the Tax Court) neither the audit report covering 1959 and 1960 nor the audit report covering 1961 contains the slightest comment or any other "specific evidence" that the depreciation deductions on the Chicago Property as shown on the returns of Harold and Beulah Graves were examined (R. 62).

SPECIFICATIONS OF ERROR

Petitioners contend the Tax Court of the United States erred as follows:

1. In failing to properly apply the doctrine of Massey Motors vs. United States that economic useful life is measured by use in the taxpayer's particular business, not by the full abstract economic life of the asset in any business, or by reference to similar types or class of assets. As a result of such failure, the Tax Court rejected Plaintiff's definition of economic useful life and disregarded the testimony of Petitioners' expert witness based thereon.
2. In accepting the testimony of the Commissioner's expert witness as the basis for the Court's findings concerning economic useful life.
3. In failing to admit evidence establishing a fair market value for the Chicago Buildings below their depreciated basis on a date subsequent to the years at issue.
4. In failing to hold that subsection 3.05, part II of Revenue Procedure 62-21 precludes the Commissioner from making the depreciation adjustments for the subject years.

SUMMARY OF ARGUMENT

The Tax Court completely disregarded the testimony of Petitioners' expert witness concerning the economic useful lives of the Chicago Buildings because it was based on what the Tax Court considered an erroneous definition of economic useful life. Petitioners believed the doctrine of Massey Motors vs. United States, 364 U.S. 92 (1960) required that the general definition of economic useful life should be tailored to the leasing business in which Petitioners employed the Chicago Buildings and such tailored definition be used as the basis for the testimony of their expert witness.

Application of the basic depreciation concept in Massey Motors to fit Petitioners' business produced the following restatement of the basic definition: How long can a building leased for a monetary return be expected to function profitably in the leasing business? A building ceases to function profitably in the leasing business when it contributes nothing to the lessor's return so Petitioners employed the following definition of economic useful life as a basis for the testimony of their expert witness:

How long it takes before the return on the land plus the building would be no more than the return on the land alone.

Determination of economic useful life under Petitioners' definition requires a knowledge of market reaction, demand and supply, and highest and best use of the land. The testimony of Petitioners' expert witness emphasized these economic factors. Evidently, emphasis on the economic factors accounts

for the Tax Court's rejection of Petitioners' definition and the testimony based thereon.

The Tax Court saw no difference between criteria to be used in determining economic useful life for a building employed by a taxpayer in his own manufacturing and distributing business on the one hand, and determining economic useful life of buildings held for monetary return through leasing, on the other hand.

Petitioners believe the situations are quite different. In the case of determining economic useful life for buildings used in the taxpayer's own manufacturing and distributing business, physical features have an adverse impact only to the extent they affect the particular use. In contrast, when buildings are held for monetary return through leasing to others, physical defects decrease the number of potential lessees thereby shortening the period of time that the buildings can be expected to function profitably in the leasing business.

Petitioners' expert witness, Mr. Walther, testified that the Chicago Buildings did not represent the highest and best use of the land because of built in obsolescence due to their two-story structure and low ceilings. These features evidently did not adversely affect Sawyers, Inc., but the lease with Sawyers, Inc. will expire August 31, 1969, and thereafter the ability of the buildings to function profitably in Petitioners' leasing business will feel the impact of the obsolescence factors.

If Petitioners are correct in their assertion that economic considerations are paramount in determining the economic useful life of buildings held for monetary return from leasing, the testimony of the Commissioner's expert witness should be accorded little weight. All of his education and background was engineering, with no economic background. The most pertinent portions of Mr. Kenney's testimony were directed to industrial buildings in general, located in the particular Chicago area. This is contrary to the mandate of Massey Motors which expressly states that the economic useful life is based upon the particular asset employed in the particular business, not on the basis of types or classes of assets.

The Tax Court erred in failing to admit an appraisal report made by Mr. Walther which shows a November 3, 1964 fair market value for the Chicago Buildings below Petitioners' depreciated basis for same. Fribourg Navigation Co., Inc. vs. Commissioner, 383 U.S. 272 (1966) recognizes that the establishment of a fair market value above depreciated basis may be some evidence of a miscalculated economic useful life, particularly where there is no appreciation in value to account for same. The reverse should be equally true, - establishment of a fair market value below depreciated basis should be some evidence that the original estimate of economic useful life was not miscalculated.

Two revenue agents reviewed the tax returns of Harold and Beulah Graves and issued audit reports without proposing any depreciation adjustments for the Chicago Buildings.

The returns contained a depreciation schedule clearly setting forth the 25 year lives for the buildings and the 5 year lives for the components. Revenue Procedure 62-21, Subsection 3.05, Part II precludes depreciation adjustments where prior audit reports contain evidence that the depreciation deductions were examined. The facts set forth on pages 11-14 above show that the depreciation deductions were examined thereby invoking the prohibition of Revenue Procedure 62-21.

FIRST SPECIFICATION OF ERROR

The Tax Court erred in failing to properly apply the doctrine of Massey Motors vs. United States that economic useful life is measured by use in the taxpayer's particular business, not by the full abstract economic life of the asset in any business, or by reference to similar types or class of assets. As a result of such failure, the Tax Court rejected Plaintiff's definition of economic useful life and disregarded the testimony of Petitioners' expert witness based thereon.

ARGUMENT

If economic useful life of a building were determined on the basis of types or classes, or upon full abstract economic life, it would make no difference whether a building were used in the taxpayer's own manufacturing and distributing business, or whether the buildings were held for monetary return through leasing. However, as made clear in the following quotations from Massey Motors vs. United States, 364 U.S. 92 (1960), determination of economic useful life is an individualized matter (364 U.S. at 97 and 98):

" . . . the wear and tear to the property must arise from its use *in the business* of the taxpayer--i.e., useful life is measured by the use in a taxpayer's business, not by the full abstract economic life of the asset in any business. . . ."

.....

" . . . the use and employment of the property

in the business relates to the trade or business of the taxpayer--not, as is contended to the type or class of assets subject to depreciation. . ."

Under the doctrine of Massey Motors, a generalized definition of economic useful life must be tailored to the particular business before it can furnish guidance for expert testimony. The tailoring, of course, must be premised on a sound basic concept. Petitioners utilized as their premise the basic concept reiterated in the following extract from Massey Motors vs. United States, 364 U. S. at 96:

" . . . It was the design of the Congress to permit the taxpayer to recover, tax free, the total cost to him of such capital assets; hence it recognized that this decrease in value--depreciation--was a legitimate tax deduction as business expense. It was the purpose of § 23 (1) and the regulations to make a meaningful allocation of this cost to the tax periods benefited by the use of the asset. In practical life, however, business concerns do not usually know how long an asset will be of profitable use to them or how long it may be utilized until no longer capable of functioning. But, for the most part, such assets are used for their entire economic life, and the depreciation base in such cases has long been recognized as *the number of years the asset is expected to function profitably in use*. . ." (emphasis added)

Petitioners employed the Chicago Buildings in the trade or business of leasing. The objective of leasing is production of a monetary return. Application of the basic depreciation concept to fit the particular business produces the following restatement of the above emphasized quotation from Massey Motors: How long can a building leased for monetary return be expected to function profitably in the leasing business? A building ceases to function profitably in the leasing business when the building contributes nothing to the lessor's return.

A building contributes nothing to the lessor's return when the return on the land plus the building is no more than the return on the land alone. The foregoing reasoning led Petitioners to the following individualized definition of economic useful life upon which Petitioners' expert witness based his testimony:

How long it takes before the return on the land plus the building would be no more than the return on the land alone.

Petitioners' definition is more restrictive than required by the Law. A building might return a small amount over and above that which could be obtained from the land alone, but the building nevertheless outlived its usefulness if a substantially greater return could be obtained from a new building after making allowance for the additional rent required to recapture the cost of the new construction. Such would be the case where the location outgrows the building. In Heart of Atlanta Motel, Inc. vs. United States, 63-1 USTC par. 9402 (N.D. Ga.) the court instructed the jury as follows concerning economic useful life:

". . . if you should conclude that at the end of a particular time which you determine the land will have such greater value for other purposes as to make it advantageous to the owners to remove the present improvements, then you would be justified in finding that the useful economic life terminates at that point if you conclude that it is reasonable to predict that within a certain period of time it will be economically or commercially expedient for these properties to be replaced with improvements more in keeping with the value of the land, then you would be justified in selecting that period as a useful economic life." Id. at 88,073-88,074

Under such instructions, improvement in the location will shorten, rather than lengthen the economic useful life. A more accurate

definition of economic useful life for leased property might well be: The number of years until the lessor's financial self interest will dictate replacing the building.

In an effort to avoid controversy, Plaintiffs adopted the restrictive definition above mentioned. It seems irrefutable that a building held by an investor for a monetary return through leasing will have ceased to function profitably in use when the return on the land plus the building is no more than the return on the land alone. Yet, the Tax Court calls this definition "unique" (R. 65), and far afield from recognized concepts (R. 66).

No authority is cited by the Tax Court for its assertions, other than Massey Motors, Inc. vs. Commissioner, supra, and United States vs. Ludey 274 U. S. 295 (1927), a case cited in Massey. As discussed above, Massey Motors is the very case which Petitioners followed in deriving their definition.¹ Perhaps, the key to the Tax Court's reaction is contained in the observation that Plaintiff's definition "seems to involve such things as 'market reaction', 'recapture rates' and the 'highest and best use of a parcel of land.'" (R. 65) Evidently the Tax Court feels any definition of economic useful life which takes such factors into consideration must be wrong. Petitioners, on the other hand, believe that economic factors such as these are paramount in the case of property

1. In United States vs. S & A Company, 338 F. 2d 629 at 634 (8th Cir. 1964) the court observes that Massey Motors refines the approach of United States vs. Ludey. It is the refinement which Plaintiffs have endeavored to capture in their definition of economic useful life for property held for monetary return from leasing.

held for monetary return through leasing.

Importance of economic factors is not a peculiarity of Plaintiff's definition, but applies equally if the basic concept of Massey Motors is rephrased as follows to reflect the particular business involved:

How long can a building leased for monetary return be expected to function profitably in the leasing business?

Whether a building represents the "highest and best use of the land" has a material bearing upon how long the building will function profitably. Certainly, a building constituting the highest and best use of the land can be expected to function profitably longer than a building having built in obsolescence as did the Chicago Buildings.

Petitioners' expert witness, H. O. Walther, testified that the Chicago Buildings had considerable built in obsolescence due to their two story structure and the low ceiling heights (testimony quoted at page 9 above). The two story type building because of the vertical nature of doing business, is not in the same demand as one story property (Tr. 87). As labor costs go up, two story low ceiling building become more and more obsolescent because the labor of moving goods vertically as against moving goods horizontally becomes high thereby shortening the economic useful life (Tr. 46). Similarly, the size of the bays in the Chicago Buildings reduced the demand over what it would be if the bays were larger (Tr. 88).

As Mr. Walther testified, determination of economic useful life under Petitioners' definition requires a knowledge

of market reaction, demand and supply and the adequacy of the present building and surroundings and what it takes to handle the demand and supply (Tr. 87). This is equally true if the above rephrased basic concept of Massey Motors is used instead of Petitioners' definition. How long a building leased for monetary return can be expected to function profitably in the leasing business certainly is affected by market reaction, demand and supply, not only that resulting from physical characteristics, but also that resulting from outside factors such as availability of other buildings and general market conditions in the leasing field.

A different situation is presented when determining economic useful life for a building used by the taxpayer in his own manufacturing and distributing business. The economic benefit which such a taxpayer derives from the use of his own building is not dependent upon supply and demand for the building. He has satisfied the demand through his own use. Physical features have an adverse effect only to the extent they affect him in his particular use and reduce the probable time he can profitably use the building. If two stories and low ceilings did not affect use of the Chicago Building by Sawyers, Inc. such physical characteristics had no impact upon economic useful life to Sawyers. The situation was changed when Petitioners took over the Chicago Buildings for use in the business of leasing.

Upon acquisition of the Chicago Buildings on September 1, 1959, Petitioners leased the buildings back to Sawyers, Inc. However, Sawyers, Inc. is not obligated under the lease beyond

August 31, 1969. Petitioners would have been willing to extend the lease for a longer period, but Sawyers, Inc. declined to accept the obligation (Tr. 56). Rather, Sawyers, Inc. paid Petitioners \$15,000 for an option to renew the lease for a five year term from September 1, 1969 through August 31, 1974 (R. 36, Stip. para 11). If Sawyers, Inc. knew it wanted the Chicago Buildings through August 31, 1974, it would have executed a firm lease as desired by Petitioners, rather than pay \$15,000 for an option. At the time of the Tax Court hearing on June 30, 1966, Harold Graves had no assurance or expectation that the option would be exercised (Tr. 56). August 31, 1969 termination of the lease is 15 years short of the 25 year economic useful life assigned to the Chicago Buildings by Petitioners. After August 31, 1969, the monetary return receivable by Petitioners will be subject to the economic factors considered by Mr. Walther in giving his opinion.

SECOND SPECIFICATION OF ERROR

The Tax Court erred in accepting the testimony of the Commissioner's expert witness as the basis for the Court's findings concerning economic useful life.

ARGUMENT

If Petitioners are correct in their assertion that economic, not physical, considerations are paramount in determining economic useful life of building held for monetary return from leasing, the testimony of Commissioner's expert witness should be accorded little weight. All of his education and background was engineering, with no economic background in regard to real property (Tr. 67 - 69). This is not to disparage Mr. Kenney. There may be depreciation cases where physical useful life is the dominant consideration. In such cases, Mr. Kenney can offer valuable testimony. Here, there is no issue concerning physical useful life. Likewise there is no controversy concerning the physical characteristics of the buildings. Rather, the question is the economic impact that the physical characteristics have upon the length of time the Chicago Buildings will function profitably in generating a return to Petitioners as lessors. What qualifications does Mr. Kenney have for such a determination?

Actually Mr. Kenney recognized his limitations by giving general answers to the three questions asked him involving economic aspects. In answer to the question concerning his opinion as to the general demand for buildings and rental space as a factor in

determining useful life of Chicago Buildings, Mr. Kenney stated (Tr. 81):

Buildings of this type, one and two story structures, are in great demand at all places throughout Chicago, particularly in this area, service and set up for light manufacturing activities.

As stated in Massey Motors, supra, economic useful life is not determined by reference to type or classes of assets. It is the particular asset with its particular characteristics which controls.

The most pertinent question asked Mr. Kenney was his opinion as to the present and potential use of the buildings as a factor in determining useful lives of the buildings and their components. Mr. Kenney answered as follows (Tr. 81):

"The present location is an excellent position. My opinion is there is none other in Chicago that can rate with it. It is central is [sic] population, it has possibilities and great possibilities for utilization as office space, warehouse space, light manufacturing, particularly electronics and other assembly operations."

Here again Mr. Kenney's testimony concerned buildings in general, limited only to a particular area of Chicago.

Mr. Kenney testified that the highest and best use of the Chicago property was for industrial buildings (Tr. 83). Therefore, concluded Mr. Kenney, the Chicago Buildings represented the highest and best use of the land because they were industrial buildings. Petitioners' expert witness does not quarrel with the proposition that industrial buildings represent the highest and best use of the land. The question, however,

is whether these particular buildings represent the highest and best use. Mr. Kenney's generalized reasoning that the Chicago Buildings were the highest and best use of the land because they were industrial buildings, and the particular location was zoned for industrial, represents the generalized approach to economic useful life condemned in Massey Motors.

THIRD SPECIFICATION OF ERROR

The Tax Court erred in failing to admit evidence establishing a fair market value for the Chicago Buildings below their depreciated basis on a date subsequent to the years at issue.

ARGUMENT

In Fribourg Navigation Co., Inc. vs. Commissioner, 383 U.S. 272 at 277 (1966) the Supreme Court held that sale of an asset for an amount greater than its depreciated basis did not in and of itself prove the taxpayer had miscalculated economic useful life of the asset, particularly where the increased price was due to an unexpected, short-lived but spectacular appreciation in value resulting from a change in the world market. The Supreme Court recognized, however, that such a sale establishing fair market value may constitute some evidence of an erroneously determined economic useful life.

If establishment of a fair market value above depreciated basis is evidence of a miscalculated economic useful life, then establishment of a fair market value below depreciated value should constitute evidence supporting the original determination of economic useful life. At the Tax Court hearing, Petitioners attempted to introduce an appraisal made by Mr. Walther which showed a November 3, 1964 fair market value for the Chicago Buildings below Petitioners' depreciated basis for same. Counsel for Petitioners explained to the Tax Court that the evidence

would negate any reduction in fair market value from September 1, 1959 to the date of the appraisal. With reduction in fair market value eliminated as an explanation, Petitioners could not have taken excessive depreciation through the years at issue because excessive depreciation would have resulted in a depreciated basis below fair market value rather than vice versa. Nevertheless, the Tax Court rejected introduction of the appraisal.

Massey Motors vs. United States, 364 U.S. at 101 contains the following statement:

"...Furthermore, as we have said, Congress intended by the depreciation allowance not to make the taxpayers a profit thereby, but merely to protect them from a loss." (emphasis added)

Since Petitioners are entitled to protection against loss through the depreciation allowance, they should be permitted to show receipt of less than the intended protection as a defense to the Commissioner's assertions of excessive depreciation. The appraisal will make such a showing.

FOURTH SPECIFICATION OF ERROR

The Tax Court erred in failing to hold that subsection 3.05, part II of Revenue Procedure 62-21 precludes the Commissioner from making the depreciation adjustments for the subject years.

ARGUMENT

The purpose and approach of Revenue Procedure 62-21 is capsulized in the second paragraph of Section 1, part II quoted below (1962-2 Cum. Bull. at 429):

" The determination of the useful economic life of an asset is a matter of judgment and estimate. For this reason, it is the policy of the Internal Revenue Service generally not to disturb depreciation deductions. Therefore, adjustments in the depreciation deduction should not be proposed unless there is a clear and convincing basis for a change. The procedures set forth herein are to be followed in determining whether there is a clear and convincing basis for a change. These procedures are designed to provide taxpayers with a greater degree of certainty in determining the amount of their depreciation deductions and to provide greater uniformity in the audit of these deductions by the Internal Revenue Service."(Emphasis added).

Since the professed objective of Revenue Procedure 62-21 is to provide taxpayers with greater certainty, and to provide greater uniformity upon audit, it was natural that the procedure should expressly cover the assertion of depreciation adjustments where there has been a prior audit. Accordingly, Subsection 3.05, part II, 1962-2 Cum. Bull. at 433 supplemented by the answer to question 49, 1962-2 Cum. Bull. at 477 precludes the Commissioner from adjusting depreciation where an audit report contains comments that the depreciation deduction has been examined but not

adjusted, or where other specific evidence indicates that the depreciation deduction was examined. The two audit reports covering returns of Harold and Beulah Graves are identified in the first paragraph on page 13 above. The Tax Court held that neither of these audit reports contains the slightest comment or other specific evidence that the depreciation deductions on the Chicago Property as shown on the returns of Harold and Beulah Graves were examined. (R. 62).

The pertinent facts concerning the Revenue Procedure 62-21 issue are set forth on pages 11 through 14 above. Page 14 is a Xerox copy of the summary schedules contained in the two audit reports. The figures opposite item 5 entitled "Rents and Royalties" on each schedule were taken from the rental income and depreciation schedules for the Chicago Buildings (copy on page 12 above). These figures could not have been placed on the audit report summary sheets unless the rental income and depreciation schedules for the Chicago Buildings had been examined. This rental income and depreciation schedule (page 12 above) clearly specifies 25 year lives for the buildings and 5 year lives for the components. The words "No Change" written on each of the audit report summary schedules (page 14) is a comment that no adjustments were made in the items reflected thereon. One of the items to which the "No Change" comment applies is the loss figure taken from the rental income and the depreciation schedule for the Chicago Buildings which schedule clearly sets forth the depreciation deduction and the economic useful lives employed in deriving same.

A narrow interpretation should not be given "examined" if Revenue Procedure 62-21 is to accomplish its avowed purpose of providing taxpayers with greater certainty. Two different agents reviewed the returns of Harold and Beulah Graves without proposing changes in depreciation. It seems most strange to tell the Graves that the depreciation deductions were not examined.


The returns of Harold and Beulah Graves having been "examined", Revenue Procedure 62-21 precludes alteration of the useful lives utilized by the Petitioners. Thus, regardless of whose expert witness is to be believed or the import of such testimony, the depreciation deduction taken by the Petitioners cannot be disturbed.

CONCLUSION

For the reasons set forth above, this Court should reverse the decision of the Tax Court and allow Petitioners an annual depreciation deduction for the fiscal years here in dispute computed on the basis of a 25 year useful life for the Chicago Buildings and a 5 year useful life for the components of the Chicago Buildings.

Respectfully submitted,

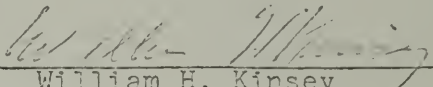
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CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of The United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.



William H. Kinsey

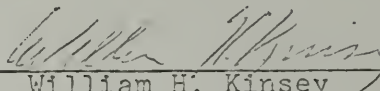
Of Attorneys for Appellants

APPENDIX "A"

Exhibit No.	Identified	Offered	Received
Stipulation and Respondent's Exhibits Nos. 1-A through 24-X	33	33	33
Petitioner's Exhibit No. 25	35	36	-
Petitioner's Exhibits Nos. 26 and 27	49	50	50
Petitioner's Exhibit No. 28	52	52	52
Respondent's Exhibit Y	73	74	74
Respondent's Exhibit Z	74	74	74
Respondent's Exhibit AA	77	77	77

CERTIFICATION OF SERVICE

I, WILLIAM H. KINSEY, attorney for Appellants, hereby certify that I served by mail three true and correct copies of the Appellants' Brief on counsel for the Commissioner of Internal Revenue on the 7th day of October, 1967. I further certify that the copies were placed in a sealed envelope addressed to Mitchell Rogovin, Assistant Attorney General, Department of Justice, Washington, D.C. 20530; said sealed envelope was then deposited in the United States Post Office at Portland, Oregon on the day last mentioned with the postage thereon fully paid.



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